EASTERN PROVINCIAL AIRWAYS
Annual Report 1977

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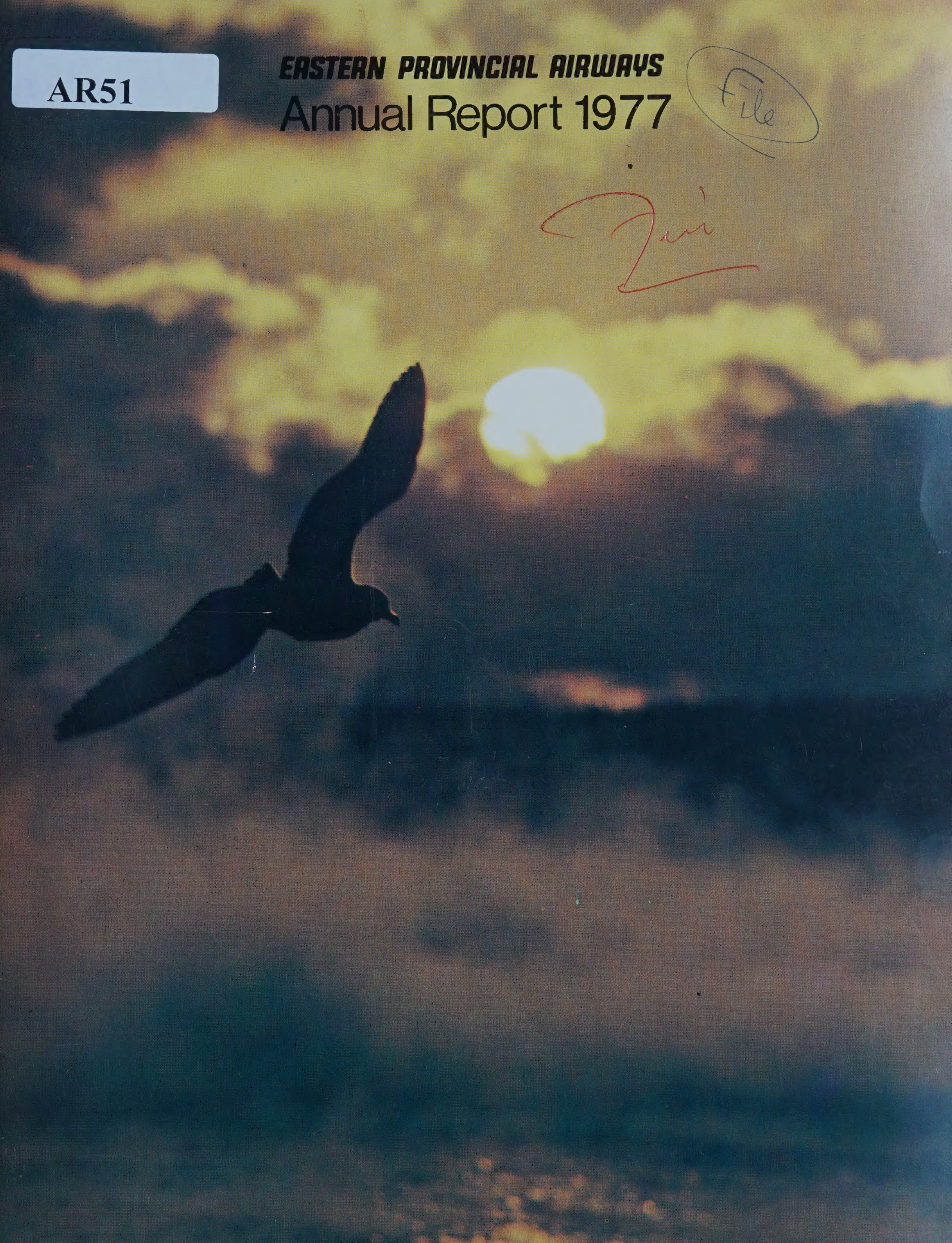


EASTERN PROVINCIAL AIRWAYS LIMITED
and Subsidiary Companies

OFFICERS

Andrew Chesley Crosbie,
Chairman of the Board

Arthur James Lewington,
Deputy Chairman of the Board

Keith Alfred Miller,
President and Chief Executive Officer

William Farrell Gaudet,
Vice-President Marketing

William Henry Harris,
Vice-President Government and Community Relations

Bryan Goodwin Jones,
Vice-President Engineering & Maintenance

Marshall Bruce Jones
Vice-President Flight Operations

Harold Lewis Wareham
Vice-President Finance & Planning

William James Whatley
Secretary

Roy Preston Rideout
Assistant Vice-President Finance

HEAD OFFICE
Gander International Airport,
Gander, Newfoundland

BANKERS
The Royal Bank of Canada, Gander, Nfld.
The Mercantile Bank of Canada, Montreal, P.Q.

AUDITORS
Peat, Marwick, Mitchell & Co.,
Chartered Accountants,
St. John's, Newfoundland

LEGAL COUNSEL
Herridge, Tolmie,
Ottawa, Ontario
Johnston, Heenan & Blaikie,
Montreal, P.Q.
Alyward & Crosbie,
St. John's, Newfoundland

TRANSFER AGENT & REGISTRAR
The Royal Trust Company,
St. John's, Halifax, Montreal,
Toronto, Winnipeg, Regina, Calgary

STOCK LISTING
The Toronto Stock Exchange
The Montreal Stock Exchange

DIRECTORS
Andrew Chesley Crosbie,
President & Chief Executive Officer,
Newfoundland Engineering and Construction Co. Ltd.,
St. John's, Nfld.

Arthur James Lewington,
Deputy Chairman of the Board,
Eastern Provincial Airways

**Keith Alfred Miller,
President & Chief Executive Officer,
Eastern Provincial Airways

Walter John Cox,
President, The Pure Milk Co. Ltd.,
Charlottetown, P.E.I.

John M. Coyne,
Partner, Herridge, Tolmie,
Ottawa, Ontario.

William E. Fearn
Deputy Minister of Finance
Province of Newfoundland & Labrador

*William Farrell Gaudet,
Vice-President, Marketing
Eastern Provincial Airways

*William Henry Harris,
Vice-President, Government & Community Rels.
Eastern Provincial Airways

*Bryan Goodwin Jones,
Vice-President, Engineering & Maintenance
Eastern Provincial Airways

*Marshall Bruce Jones
Vice-President, Flight Operations
Eastern Provincial Airways

Richard Henry Oland,
Officer Moosehead Breweries Limited,
Saint John, N.B.

Charles Arnold Patterson
President, C.F.D.R. Radio Station
Dartmouth, Nova Scotia

Alexander J. Roche
Deputy Minister of Industrial Development
Province of Newfoundland & Labrador

Harold Raymond Steele,
President, Atlantic Inns Limited
Gander, Nfld.

*Harold Lewis Wareham,
Vice-President, Finance & Planning
Eastern Provincial Airways

*Members of the Executive Committee
**Chairman of the Executive Committee

Contents

EASTERN PROVINCIAL AIRWAYS LIMITED
and Subsidiary Companies

Comparative Highlights

	1977	1976
Earnings		
Revenues - Gross	$46,361,000	38,651,000
Net Loss	1,215,000	1,083,000
Loss per Common Share - Basic	1.12	1.03
Average Common Shares Outstanding	1,202,595	1,202,545
Financial Position		
Working Capital Deficiency	656,000	683,000
Property and Equipment - Net	28,418,000	25,831,000
Long-Term Debt	20,883,000	16,591,000
Shareholders' Equity	4,862,000	6,179,000
Equity per Common Share	2.57	3.58
Operating Statistics		
Passengers Carried	669,000	593,000
Cargo Ton Miles	3,871,000	3,876,000
Revenue Ton Miles	29,580,000	26,340,000
Capacity Ton Miles	53,198,000	50,836,000
Revenue Weight Load Factor	55.6%	51.8%

Directors' Report to the Shareholders

During 1977 the company incurred a net loss for the year of $1,215,000 or $1.12 per share, compared with a net loss of $1,083,000 or $1.03 per share for the preceding year. This comparison, however, is distorted since 1976 results included a significant non-operating gain on the sale and lease-back of a Boeing 737 aircraft which reduced the 1976 net loss by $830,000 or $0.69 per share. Discounting the effect of this gain the 1976 loss was $1,913,000 or $1.72 per share. Effectively, in spite of the loss situation, the year 1977 did show a significant improvement over 1976 operating results.

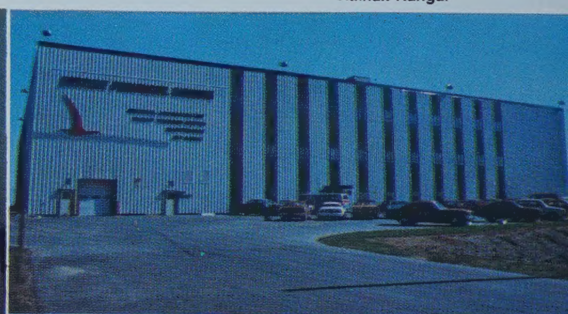
Revenues from all sources increased by 20% to $46,361,000 compared with total revenues in 1976 of $38,651,000. Operating expenses, excluding fixed ownership costs, amounted to $40,917,000 whereas in 1976 these expenses totalled $35,520,000, an increase of 15%.

The increase in revenues results primarily from a 24% increase in scheduled passenger revenues accruing from fare increases in May and September of 1976 and April of 1977 combined with traffic growth of 13%. The revenue growth was achieved despite the four day shut-down of the airline's operations caused by the work stoppage of the nation's air traffic controllers in August of 1977. This work stoppage occurred during the busiest period of the year and is estimated to have cost the airline between $400,000 and $500,000. Additional revenues were derived from the first year's operation of the company's new hotel in Dartmouth, Nova Scotia, which was acquired on January 1, 1977. The 15% increase in operating expenses is attributed to inflationary pressures in all cost areas, led by aviation fuel and labour, combined with volume increases associated with the growth in traffic and the operation of the new hotel.

Since your management forecasted a difficult year well in advance, certain steps were taken early to improve operating results during 1977 and maintain a sufficient level of working capital. A Boeing 737 aircraft was leased to Aloha airlines in Hawaii for a period of six months. This lease agreement had the effect of reducing idle aircraft capacity and contributed approximately $500,000 to revenues. To restore depleted working capital a bank loan was arranged which provided $4,500,000 in funds at a favourable interest rate. It is the company's intention to refinance this loan in 1979. In view of the airline's operating results and working capital position, dividends were not

Boeing 737 Flight Simulator

Halifax Hangar



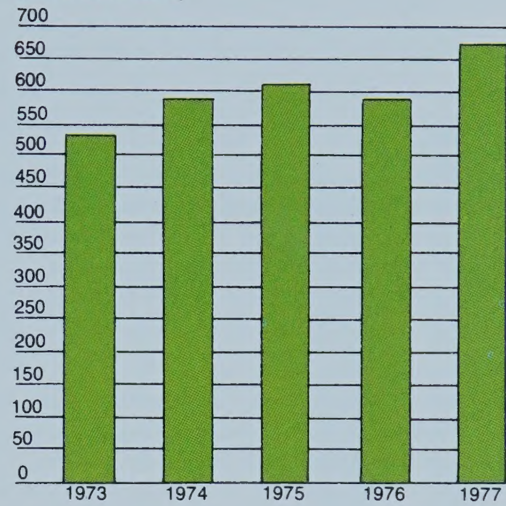
paid on either common or preferred shares during the year.

Further economies were achieved through stringent payload and capacity control. While revenue passenger miles increased by 15%, capacity seat miles increased only marginally. This resulted in greatly improved revenue passenger load factors — 52.7% in 1977 compared with 47.3% in 1976. Despite the substantial increase in traffic the average number of people employed by the airline increased by only 5, to 830 in 1977 from 825 in 1976. This reflects a substantial improvement in employee productivity. On charter and scheduled operations combined, the airline produced 48,857 revenue ton miles per employee in 1977 compared with 46,524 during 1976.

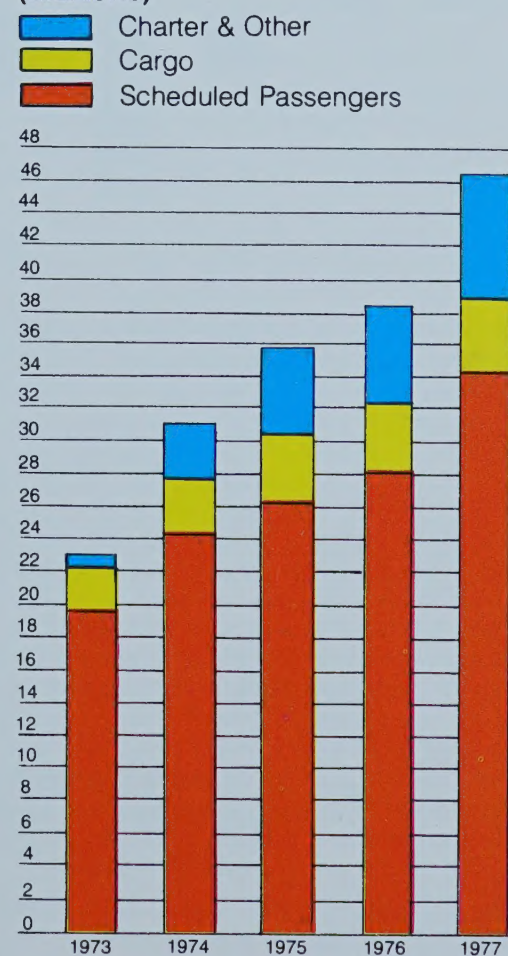
Included in total revenues for both 1976 and 1977 is an amount of $1,700,000 paid annually to the airline for the provision of air service over certain uneconomic routes which are eligible for federal subsidy. Much has been said about this subsidy in previous reports and the fact that it was arbitrarily frozen at the 1974 level by the federal government. During 1977, as in the two preceding years, the losses incurred on subsidy-eligible routes were substantially in excess of the subsidy paid. The total subsidy claimed for the year 1977 was $3,277,000 which compares to the 1976 claim of $3,372,000. As a result of the rejection by the Ministry of Transport of the company's appeal for relief from this subsidy restriction the airline cut back certain subsidy-eligible services during 1977. No further cut backs can be effected without causing a serious deterioration in the level of air services needed for the economic development of Atlantic Canada. The airline has been advised by the Canadian Transport Commission that 1978 subsidies will again be restricted to $1,700,000 and that no decision has in fact yet been made by federal authorities on the amount of subsidy, if any, available beyond 1978.

In view of the uncertainty of the existing arrangements the airline, as a result of comprehensive studies conducted by its own research staff and the staff of the de Haviland Aircraft Company of Canada, has approached federal authorities again with a complete new proposal pertaining to the upgrading of service on subsidy-eligible routes. This proposal entails the use of Dash 7 aircraft which could be delivered by the spring of 1979 and in operation for the balance of that year. However, no Dash 7 operation will be commenced by the airline without some kind of five year guarantee of subsidy levels by the Government of Canada. It is the view of the airline that the proposal

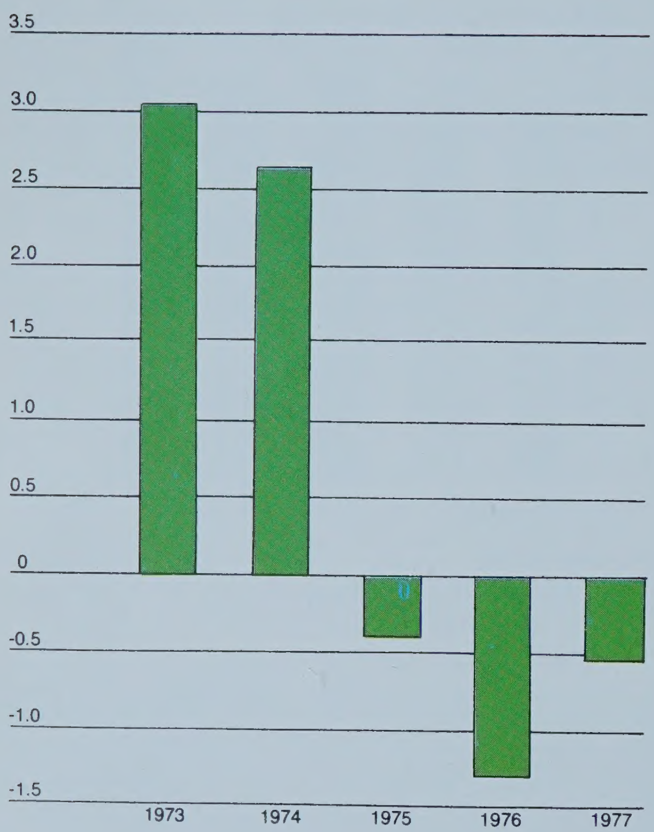
PASSENGERS CARRIED
SCHEDULED SERVICES
(THOUSANDS)



REVENUE
(MILLIONS)



FUNDS GENERATED FROM OPERATIONS
(MILLIONS)



presented to the government provides the most desirous level of service at the least cost. Furthermore, it is the view of the airline that the services are in the public interest and are vital to the economic development of our region. As of this writing, negotiations are continuing between the airline, the de Haviland Aircraft Company, the Ministry of Transport, the Department of Industry, Trade and Commerce and the Department of Regional Economic Expansion. No new precedents are being set because all routes operated are, in the opinion of your management, eligible for subsidy under the policy set down by the Government of Canada in 1966. In fact, subsidies have been paid on these routes for more than a decade and have been insufficient only since the federal government imposed a dollar ceiling at the very time that the economics of air transportation were adversely affected by the fuel crisis and the serious downturn in traffic induced by the accompanying recession.

The subsidy uncertainty is the most pressing issue facing the airline. It relates to the provision of turbo-prop services on certain low density and/or short haul routes in the Maritime Provinces. Present services are in many respects inadequate and the existing subsidy level precludes any meaningful improvement in these services. It has been stated earlier that no further curtailment in service can be effected without a serious disruption of the air travel patterns of Atlantic Canada. However, the dilemma facing the airline is that it can no longer continue to cross-subsidize these routes which are socially necessary and eligible for federal subsidy. Accordingly, if no agreement can be reached with the government it may well be necessary for the airline to apply for outright abandonment of several of the routes and for a decrease in service on others which will result in an inadequate level of service being offered.

The airline was encouraged in the latter part of 1977 when it was able to achieve an agreement with the national carrier on certain route duplications which have been discussed in prior reports. As a result of this agreement some route duplications were eliminated during February of this year and certain others will be eliminated at the end of April 1978. It is the opinion of the airline that this agreement enhances the economic viability of both airlines and also provides a better service for the travelling public. The ultimate goal of your management continues to be the establishment of the primacy of your airline on all intra-regional routes to provide a sound revenue base and improve the long run prospects for the airline. For the first time in many years the airline has no substantial disagreement with the national carrier on the role of each airline in Atlantic Canada. However, minor disagreements will always occur and the airline will continue to work with the national carrier in a positive atmosphere aimed towards improving the air services of the region.

Included in the consolidated losses for the year are the operating results of the airlines two subsidiaries: Atlantic Inns Limited and Caramac Travel Consultants Limited. The hotel subsidiary contributed a small profit to total operating results. While the newly-acquired hotel in Dartmouth, Nova Scotia, incurred a loss for the year as a result of high start-up costs and an over-abundance of hotel rooms in the Halifax/Dartmouth area, the Glynmill Inn in Corner Brook, Newfoundland, continues to show gratifying results. Consequently, a $2,250,000 expansion project for the Glynmill Inn was approved in order to renovate and improve the existing building and to construct a new 30-room wing with larger banqueting and entertaining facilities. The financing arrangements for this expansion are explained fully in the notes to the consolidated financial statements. The project should be completed by the early summer of 1978. The

airline's wholesale tour subsidiary incurred a loss in 1977. Steps have been taken to improve the situation and the subsidiary is forecasting a profit for 1978.

During the year the Canadian Transport Commission approved the airline's application for a direct turbo-prop service between Halifax, Nova Scotia, and the French islands of St. Pierre & Miquelon. It is planned that this service will commence in the summer of 1978.

The application for a non-stop service between Halifax and Montreal was not processed during 1977. The route continues to be under study by your management and no decision has yet been made as to when the application will be reactivated. It is the position of your management that the other route improvements should be effected in a satisfactory manner before any further action is taken on this application.

The major capital projects at Halifax and Gander were completed during 1977. The $7,500,000 hangar and training facility at Halifax is now fully operational. We are already experiencing the rewards of a greater ability to schedule aircraft, lower crew personnel expenses and an improved programme for flight crew training. In recent months we have contracted to train our first outside customers. These included Air Zaire, Transport Canada, Austin Airways, Bradley Air Services and Northern Wings Limited. The airline continues to seek further customers, particularly for the Boeing 737 flight training programme. The extension to the engineering and maintenance facility at Gander was completed in May 1977 and now provides additional capacity for the airline's heavy airframe maintenance program as well as housing for the company's head office personnel.

All major collective agreements expired during 1977 and new contracts were successfully negotiated. The company has recently been assessed an amount of $130,000, one half of which is to be recovered from the pilots group and one half of which is to be paid by the airline. This assessment was imposed by the Office of the Administrator and related to wages paid in 1976 and 1977 in excess of the compensation allowable under anti-inflation guidelines. In spite of the assessment the company believed it acted in good faith at the time. Most major contracts will again expire in 1978. In recent months agreements have been reached with the Canadian Airline Employees Association for the flight attendants and traffic agents groups. These agreements are now up for ratification. During the course of the next few months there will be further negotiations with the pilots group and the engineering and maintenance group.

Early in 1978 your management took certain steps which it considered prudent under existing circumstances and which are worthy of mention. A general passenger fare increase averaging 3.8% was applied for and the increase became effective on April 1, 1978. Freight rates were also increased by 5%. A Boeing 737 aircraft was leased to Aer Lingus Teoranta, the national Irish air carrier, for a period of one year commencing April 1, 1978. This lease will reduce substantially idle aircraft capacity and will provide in excess of $1,400,000 in revenues to the airline. The 1978 budgets have been subjected to an intensive review by a budget committee and expenditures for the coming year have been reduced to the minimum necessary to achieve 1978 budgeted revenues.

After three years of losses the airline is budgeting for a profit in 1978. Several factors will contribute to this turnaround. The elimination of route duplications in Atlantic Canada will have a substantially favourable revenue impact on the airline. New incentive fares introduced in the spring of 1978 are aimed at generating new revenues on empty seats. The airline plans to conduct an advance booking charter program from St. John's and Halifax to the Montreal and Toronto markets. The anticipated upturn in traffic occurred during January and February and traffic volumes in March were well in excess of those forecasted. For the full year traffic growth of between 15% and 20% is being budgeted. Despite these notes of optimism your management must emphasize that a satisfactory solution to the subsidy problem must be attained in the coming months if the airline is to prosper with the region at a desired level of profit and customer service. The resolution of this matter will be given the highest priority by your management during the coming months.

It has been shown that a substantial increase in traffic volume was achieved during 1977 with a minimum increase in staff. We are indeed gratified to acknowledge this improvement in employee productivity and extend to all employees our gratitude for their loyalty and hard work during the past year.

On behalf of the Board of Directors.

K. A. Miller

K. A. Miller,
President & Chief Executive Officer.

Consolidated Statement of Earnings

YEAR ENDED DECEMBER 31, 1977
with comparative figures for 1976
(in thousands of dollars)

	1977	1976
Revenues		
Scheduled operations	$37,462	30,898
Government subsidies - Note 7	1,700	1,700
Charter and other	7,199	6,053
	46,361	38,651
Expenses		
Operating	44,642	39,043
Depreciation and amortization	2,049	1,772
	46,691	40,815
Loss from operations	330	2,164
Other income - Note 8	82	1,501
	248	663
Interest and debt expense		
Long-term debt	1,687	1,486
Other	238	160
	1,925	1,646
Loss before deferred income taxes	2,173	2,309
Deferred income taxes	958	1,226
Net loss for the year	$ 1,215	1,083
Basic loss per Common share - Note 8	$ 1.12	1.03

See accompanying notes to consolidated financial statements

EASTERN PROVINCIAL AIRWAYS LIMITED
and Subsidiary Companies

Consolidated Statement of Changes in Financial Position

YEAR ENDED DECEMBER 31, 1977
with comparative figures for 1976
(in thousands of dollars)

	1977	1976
Funds provided by		
Government grants	$ 868	4,032
Sale of equipment	47	6,351
Long-term borrowings	7,880	4,673
Investments	61	237
Total funds provided	8,856	15,293
Funds applied to		
Net loss for the year	1,215	1,083
Items not involving funds - net	(707)	277
Funds applied to operations	508	1,360
Property and equipment	4,600	9,514
Long-term debt	3,561	5,725
Dividends	-	121
Deferred charges	58	309
Purchase for cancellation of Preferred shares - Note 5	102	80
Total funds applied	8,829	17,109
Change in working capital	27	(1,816)
Working capital (working capital deficiency) as at beginning of year	(683)	1,133
Working capital deficiency as at end of year	$ 656	683

See accompanying notes to consolidated financial statements

Assets

	1977	1976
Current assets		
Cash and term deposit	$ 143	298
Short-term investments, at cost (market value $280,000; 1976 - $507,000)	298	560
Receivables - Note 2	5,303	4,992
Materials, supplies and parts, at lower of cost or replacement cost	1,841	1,646
Prepaid expenses	416	352
Total current assets	8,001	7,848
Investments, at cost	794	894
Property and equipment, at cost		
Flight equipment	21,579	20,608
Buildings and ground facilities	13,458	9,903
	35,037	30,511
Less accumulated depreciation and provision for overhaul of owned aircraft engines	6,619	4,680
Net property and equipment	28,418	25,831
Deferred charges - Note 3	851	976
Goodwill, at cost	1,856	1,856
	$39,920	37,405

See accompanying notes to consolidated financial statements

Consolidated Balance Sheet

DECEMBER 31, 1977
with comparative figures for 1976
(in thousands of dollars)

Liabilities and Shareholders' Equity

	1977	1976
Current liabilities		
Bank indebtedness - Note 2	$ 1,719	1,423
Accounts payable and accrued liabilities	3,605	3,866
Current portion of long-term debt - Note 4	1,777	1,887
Deferred revenue	1,556	1,355
Total current liabilities	8,657	8,531
Long-term debt - Note 4	20,883	16,591
Provision for overhaul of leased aircraft engines	895	1,114
Government grants less amortization of $277,000 (1976 nil)	4,623	4,032
Deferred income taxes	-	958
Shareholders' equity - Note 5		
Capital stock	3,227	3,329
Contributed surplus	37	37
Retained earnings	1,598	2,813
Total shareholders' equity	4,862	6,179
Commitments and contingent liabilities - Note 6		
	$39,920	37,405

ON BEHALF OF THE BOARD:

K.A. Miller .... DIRECTOR
K. A. Miller

H. Wareham .... DIRECTOR
H. L. Wareham

EASTERN PROVINCIAL AIRWAYS LIMITED
and Subsidiary Companies

Consolidated Statement of Retained Earnings

YEAR ENDED DECEMBER 31, 1977
with comparative figures for 1976
(in thousands of dollars)

	1977	1976
Retained earnings as at beginning of year	$2,813	4,017
Net loss for the year	1,215	1,083
	1,598	2,934
Dividends		
Preferred shares - Series A	-	42
- Series B	-	79
	-	121
Retained earnings as at end of year	$1,598	2,813

See accompanying notes to consolidated financial statements

AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Eastern Provincial Airways Limited as at December 31, 1977 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1977 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co
Chartered Accountants

St. John's
Canada
February 27, 1978

1. Summary of Significant Accounting Policies

(a) Basis of consolidation
The consolidated financial statements include the accounts of Eastern Provincial Airways Limited and its wholly-owned subsidiary companies, Maritime Central Airways Limited, Eastern Provincial Airways (1963) Limited, and Atlantic Inns Limited, as well as its 75% owned subsidiary, Caramac Travel Consultants Limited.

Goodwill, representing the excess of cost of investment in shares of subsidiary over equity in net assets at date of acquisition amounting to $1,856,000, arose upon the acquisition of Maritime Central Airways Limited in 1963.

(b) Depreciation
Depreciation on property and equipment is provided on a straight-line basis from the date assets are placed in service at rates which are related to the estimated useful lives of the assets, as follows:

	Useful Life	Residual Value
Jet aircraft and spare parts	14 years	15%
Propeller aircraft and spare parts	10 years	10%
Buildings	20 years	-
Ground facilities	5 years	-

(c) Capitalization of interest
Interest is capitalized on expenditures related to the acquisition of property and equipment before such assets are placed in service.

(d) Overhaul provision
Provision for major overhauls of owned and leased aircraft engines which are performed by outside agencies is made based on aircraft flying time at rates per hour computed in relation to the estimated costs of the overhauls.

(e) Amortization
Deferred charges are amortized on a straight-line basis over five years with the exception of deferred financing expenses which are amortized over the terms of the related financing.

(f) Government grants
Government grants towards acquisition of property and equipment are recorded as deferred credits and amortized on the same basis as the related asset is depreciated.

(g) Revenue recognition
The recognition of revenue is deferred until the related services are rendered. Prepayments of such services as at the year end are included in deferred revenue.

(h) Foreign currency translation
Current balances receivable and payable in foreign currencies have been translated to Canadian dollars at the exchange rates prevailing as at the balance sheet date. Non-current balances in foreign currencies have been translated at historical rates of exchange. Gains and losses on translation of foreign currency are included in the statement of earnings.

(i) Income taxes
Income taxes are accounted for on the tax allocation basis in recognition of the income taxes deferred when deductions that are claimed for income tax purposes are different than corresponding expenses recorded in the accounts.

(j) Earnings per Common Share
Basic earnings per share information has been computed using the weighted average number of Common shares outstanding during the year.

2. Receivables

Receivables are summarized as follows:

	1977	1976
	(in thousands of dollars)	
Trade receivables	$4,307	3,157
Government subsidies	450	800
Recoverable construction costs	205	473
Other receivables	341	562
	$5,303	4,992

Receivables are assigned as security for bank indebtedness.

3. Deferred Charges

Deferred charges are carried at cost less accumulated amortization and are summarized as follows:

	1977	1976
	(in thousands of dollars)	
Training expenses	$282	318
Financing expenses	406	440
Crew transfer expenses	163	218
	$851	976

4. Long-Term Debt

Long-term is summarized as follows:

	1977	1976
	(in thousands of dollars)	
Bank loans:		
At prime plus 1/2% repayable in 1979	$ 6,000	-
6% repayable in 10 equal semi-annual instalments commencing July 10, 1980, secured by a chattel mortgage on an aircraft (U.S. $2,591,000)	2,562	2,562
At prime plus 2 1/8%, repayable in semi-annual instalments of $390,000 to December 31, 1979, secured by a chattel mortgage on an aircraft	1,560	2,340
At prime plus 2 1/2%, repayable in 8 semi-annual instalments commencing May 10, 1982, secured by a chattel mortgage on an aircraft (U.S. $2,285,000)	2,345	2,345
At prime plus 2%, repayable in quarterly instalments of $162,500 to March 31, 1982, and a final payment of $137,500 on June 30, 1982, secured by a chattel mortgage on an aircraft	2,900	3,550
At prime plus 2%, to be repaid in 1978	283	348
Total bank loans	$15,650	11,145
6 1/2% sinking fund debentures due March 15, 1991, less sinking fund investments of $3,999,000 (1976 - $3,889,000)	2,001	2,111
11% loan, repayable in monthly instalments of $41,000, including interest, to 1997, secured by a first mortgage on a hangar building	4,225	3,422
Current obligations to be financed from long-term borrowings - Note 6(b)	744	-
Other	40	1,800
	22,660	18,478
Less portion due within one year included in current liabilities	1,777	1,887
Long-term debt - net	$20,883	16,591

The $6,000,000 bank loan is secured by a demand note and is unconditionally guaranteed by the Province of Newfoundland to June 30, 1979, at which time the Company intends to refinance the loan on a long-term basis. By agreement, the company is not required to make payments on the loan until the expiry of this guarantee.

The sinking fund debentures are unconditionally guaranteed by the Province of Newfoundland; this guarantee being secured by a first and specific mortgage on certain assets and a first floating charge on certain other assets. It is the intention that the sinking fund investments together with future earnings of the fund will be sufficient to retire the principal amount of the sinking fund debentures at maturity.

In connection with certain loan and lease agreements the company has agreed that Eastern Provincial Airways (1963) Limited will, among other things:

(a) Maintain a minimum working capital, as defined, of $1,500,000;

(b) Maintain a minimum net worth, as defined, of $7,000,000;

(c) Not declare or pay dividends in any one year in excess of 50% of its net earnings for the previous year; and,

(d) Not make capital expenditures in excess of $500,000 in any one year without prior written consent of the lessors and lenders.

As at December 31, 1977, the company is in default of the covenants contained in these loan and lease agreements relating to working capital and net worth. However, waivers have been received from lessors and lenders stating that they do not intend to exercise their remedial rights under these agreements for the defaults existing as at December 31, 1977.

Maturities on long-term debt other than the 6 1/2% sinking fund debentures and the $6,000,000 bank loan for the five years ending December 31, 1978 through 1982 amount to $1,777,000, $1,536,000, $1,027,000, $1,299,000 and $1,503,000 respectively.

5. Capital Stock

	1977	1976
	(in thousands of dollars)	
Preferred shares of $15 par value each, issuable in series. Authorized - 135,000 shares. Series A - 6% cumulative, redeemable, convertible Preferred shares. Authorized 67,000 shares; issued and outstanding 59,940 shares.	$ 899	899

Series B - $10\frac{3}{4}\%$ cumulative, redeemable Preferred shares Authorized 68,000 shares; issued and outstanding 57,800 shares (1976 - 64,600)	867	969
Deferred shares of $100 par value each. Authorized 47,500 shares; issued and eliminated on consolidation 24,964 shares	-	-
Common shares without nominal or par value. Authorized 3,000,000 shares; issued 1,202,595 shares - stated value.	1,461	1,461
Total capital stock	$ 3,227	3,329

Pursuant to the redemption conditions attaching to the Series A Preferred shares the company is required, while there are no dividends in arrears, to apply each year to the purchase for cancellation of these shares an amount equal to three percent of the aggregate par value of Series A Preferred shares outstanding at the end of the preceding year.

Pursuant to the redemption conditions attaching to the Series B Preferred shares the company redeemed, at par value, 6,800 shares during 1977, for an aggregate consideration of $102,000, and is required to redeem, at par value, during the three years ending April 15, 1978 to 1980, 6,800 shares, 10,200 shares and 40,800 shares respectively.

As at December 31, 1977, dividends on Series A and Series B Preferred shares were in arrears in the amount of $67,000 and $122,000 respectively.

In accordance with Section 49 of The Companies Act, Newfoundland, a portion of retained earnings equal to the par value of Preferred shares redeemed to December 31, 1977, totalling $250,500, has been appropriated as a "capital redemption reserve fund" which may not be reduced or converted except in accordance with provisions of the Act. Differences between the par value of the Preferred shares redeemed and the purchase price are included in contributed surplus.

Series A Preferred shares are convertible into Common shares at the option of the shareholder on the basis of two Common shares for each Series A Preferred share. Pursuant to this conversion privilege 119,880 Common shares are reserved for issuance as at December 31, 1977. A further 99,000 Common shares are reserved for issuance to employees (other than present directors and officers) under a Stock Option Plan and a Stock Purchase Plan created in 1972. In 1974 share options were granted to employees under the Stock Option Plan to purchase 32,000 Common shares on or before December 12, 1979 at an exercise price at $2.65 per share. Pursuant to this plan options for 27,900 Common shares remain unexercised as at December 31, 1977. No shares have been offered under the Stock Purchase Plan as at December 31, 1977.

6. Commitments and Contingent Liabilities

(a) Aircraft leases

As at December 31, 1977, the company had the following aircraft lease commitments:

	Basic Annual Rental	Lease Purchase Option: Term to Option Date	Lease Purchase Option: Option Price
3 Boeing 737's	$1,702,000	7 years	Fair market value
1 Boeing 737	826,000	$7\frac{1}{2}$ years	1,200,000
1 Boeing 737	781,000	$10\frac{1}{4}$ years	1,260,000
1 Hawker Siddeley HS-748	183,000	8 years	264,000
1 Hawker Siddeley HS-748	174,000	4 years	450,000
	$3,666,000		

Related to one of the above lease agreements the company has indemnified a third party in respect of a loan which at December 31, 1977 had a balance of $7,013,000. To secure this indemnification the company has executed a specific mortgage on certain assets and a floating charge on certain other assets.

Pursuant to other lease agreements the company has pledged debentures in the amount of $575,000. These debentures are included in investments.

(b) Extension and renovation of hotel building

During the year the company commenced construction of an extension to a hotel building at a total estimated cost of $1,750,000 of which $744,000 was incurred during the year. In addition, the company plans, during 1978, to renovate the existing building at a total estimated cost of $500,000.

Subsequent to the year end the company arranged financing for these projects in the form of a $2,250,000 bank loan, and consequently the balance of $744,000 owing as at December 31, 1977 on account of these projects has been classified as long-term debt (Note 4). The bank

loan is repayable over 20 years in monthly instalments of approximately $22,800, including interest at prime plus $2^1/_2$%, commencing on August 1, 1978 and is secured by a $2,500,000 first mortgage on the property and a floating charge on certain other assets.

(c) Federal sales tax assessment
Subsequent to the year end the Federal Court of Canada upheld a federal sales tax assessment in the amount of $768,000, including interest of $180,000, against the company related to the purchase and importation of a Boeing 737 aircraft in 1973. On the advise of Counsel the company is appealing this decision. Pending the outcome of this appeal the amount of the assessment has not been recorded in the accounts as at December 31, 1977. If the appeal is unsuccessful the amount will be charged to retained earnings as a prior period adjustment.

(d) Lease of hotel building
On January 1, 1977, the company entered into an agreement to lease a hotel building for a period of five years at an annual rental of $150,000 with an option to purchase the building at any time during the lease term for the sum of $1,650,000.

7. Government Subsidies

Certain of the routes serviced by the company are eligible for federal subsidies. The Canadian Transport Commission has advised that the amount of the 1977 and 1976 subsidy allotments have been restricted to $1,700,000 in each year regardless of the cost of providing these services. Accordingly, although the company has submitted a claim of $3,277,000 (1976 - $3,372,000) for providing these services, only $1,700,000 has been recorded in the accounts in each of the years 1977 and 1976.

8. Other Income

Gains in 1976 of $1,323,000 realized from sale and leaseback transactions are included in other income and have reduced basic loss per Common share in that year by $0.69.

9. Remuneration of Officers and Directors

The aggregate direct remuneration paid by the company to its directors and senior officers for the year ended December 31, 1977, was $400,000 (1976 - $389,000).

10. Comparative Figures

Certain figures for 1976 have been reclassified to conform with the current year's presentation.

11. Anti-Inflation Act

The company is subject to restrictions on prices, profits, dividends and compensation under the Anti-Inflation Act.

Glynmill Inn, Corner Brook

Atlantic Inn, Dartmouth

	1977	1976	1975	1974	1973
Financial ($000's)					
Revenues					
Scheduled Passengers	$32,602	$26,311	$24,983	$22,637	$17,914
Cargo	4,860	4,587	3,991	3,550	2,750
Government Subsidies	1,700	1,700	1,700	1,725	1,753
Charter & Other	7,199	6,053	5,228	2,911	746
	$46,361	$38,651	$35,902	$30,823	$23,163
Expenses					
Operating	$40,917	$35,520	$32,222	$26,282	$17,933
% of Revenues	88.3%	91.9%	89.7%	85.3%	77.4%
Depreciation, Aircraft Rentals & Interest	$ 7,699	$ 6,941	$ 5,766	$ 4,177	$ 3,438
% of Revenues	16.6%	18.0%	16.1%	13.6%	14.8%
Deferred Income Taxes	$(958)	$(1,226)	$(342)	$ 342	$ 1,111
Net (Loss) Earnings	$(1,215)	$(1,083)	$(190)	$ 506	$ 1,111
Per Common Share	$(1.12)	$(1.03)	$(0.27)	$ 0.37	$ 0.88
Funds (Applied To) Provided From Operations	$(508)	$(1,360)	$(405)	$ 2,654	$ 3,084
Per Common Share	$(0.55)	$(1.23)	$(0.45)	$ 2.16	$ 2.52
Other Statistics					
Scheduled Operations					
Passengers Carried	669,000	593,000	604,000	594,000	539,000
Pass. Miles Flown (000)	257,000	225,000	238,000	239,000	216,000
Yield per Passenger Mile	12.7c	11.6c	10.5c	9.5c	8.3c
Cargo Ton Miles (000)	3,871	3,876	3,799	3,810	3,659
Yield per Cargo Ton Mile	$ 1.26	$ 1.18	$ 1.05	$ 0.93	$ 0.75
Total Revenue Ton Miles (000)	29,580	26,340	27,575	27,666	25,264
Capacity Ton Miles (000)	53,198	50,836	51,532	52,053	47,270
Revenue Weight Load Factor	55.6%	51.8%	53.5%	53.2%	53.4%
Employees at Year End	830	787	771	752	640
Revenue Ton Miles per Employee	35,600	33,500	35,800	36,800	39,500

Glossary of Terms

CAPACITY TON MILES

Number of tons capacity for the carriage of passengers and cargo multiplied by the number of miles this capacity is flown. A measure of aircraft capacity offered.

CARGO

Freight, express, mail and excess baggage.

CARGO TON MILES

Tons of freight, express, mail and excess baggage carried multiplied by the miles they are flown.

REVENUE PASSENGER MILES

Total revenue passengers carried multiplied by the number of miles they are flown.

REVENUE TON MILES

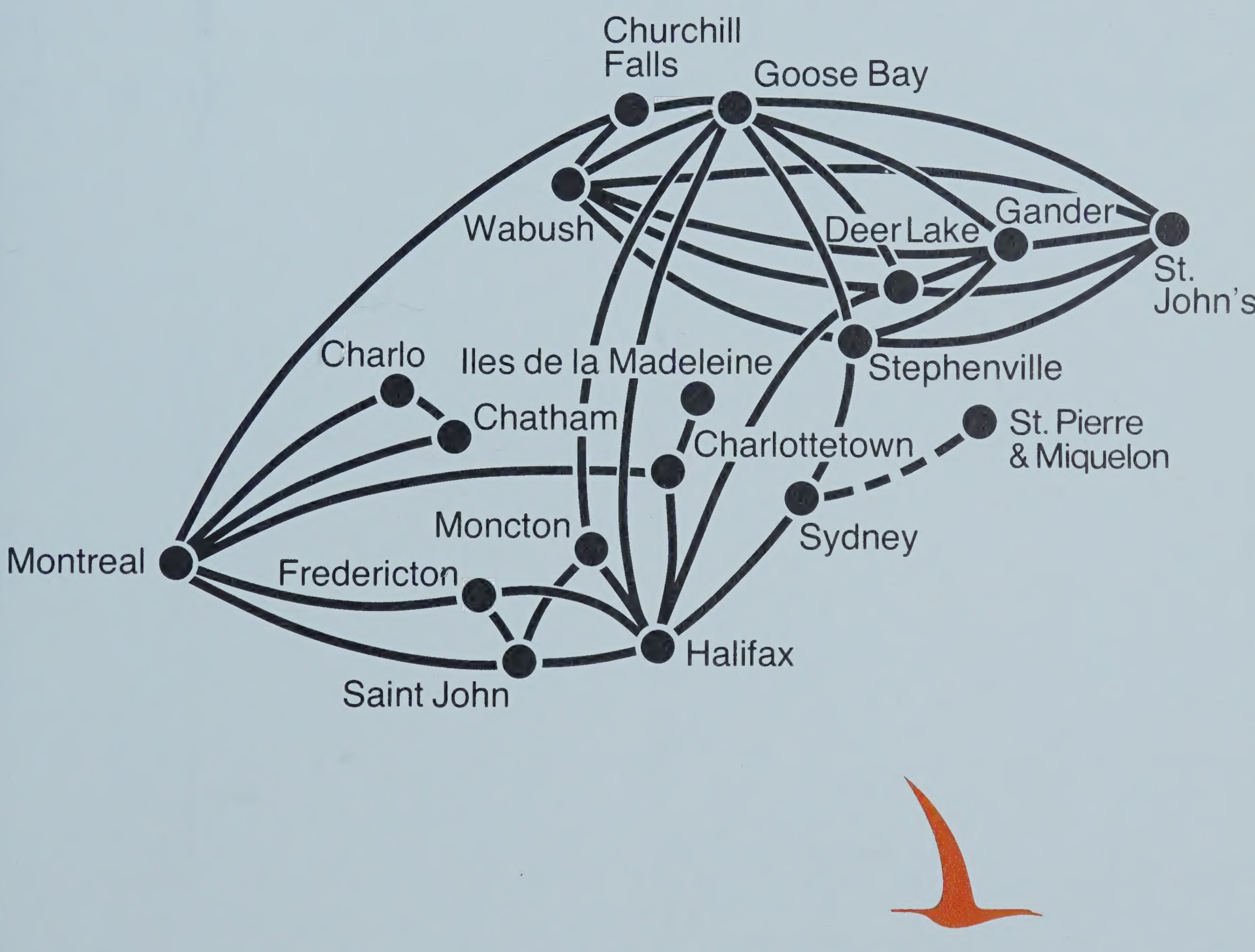
Total tons of all revenue traffic carried multiplied by the miles they are flown.

REVENUE WEIGHT LOAD FACTOR

Total revenue ton miles as a percent of the capacity ton miles.

YIELD

The average revenue per revenue passenger mile or revenue ton mile.



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